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September 27, 2000 **LETTER 1307**

MARKET ACTION: It's a lot different writing this Letter, which is mailed every three weeks, vs. writing a commentary on the Internet six days a week including Saturdays.

I follow dozens of technical and fundamental indices, but in the end I honestly believe my PTI cuts through all the puzzles and problems and provides the best and easiest-to-read answer.

As you know, my PTI turned bullish on July 11, on which day the Dow closed at 10727. Since then the Dow has risen as high as 11252 on August 28 -- and then turned down.

The PTI has recently "rolled over" (see page 2 chart) and the Dow has turned down in harmony with the PTI. As this is written, the PTI is still above its 89-day moving average, and therefore still in its bullish mode.

However, it's time to be very careful. I say this because both the bonds and the Utility Average have reversed to the downside, and with both of these in negative trends and with my PTI rolling over, the picture has become very dicey.

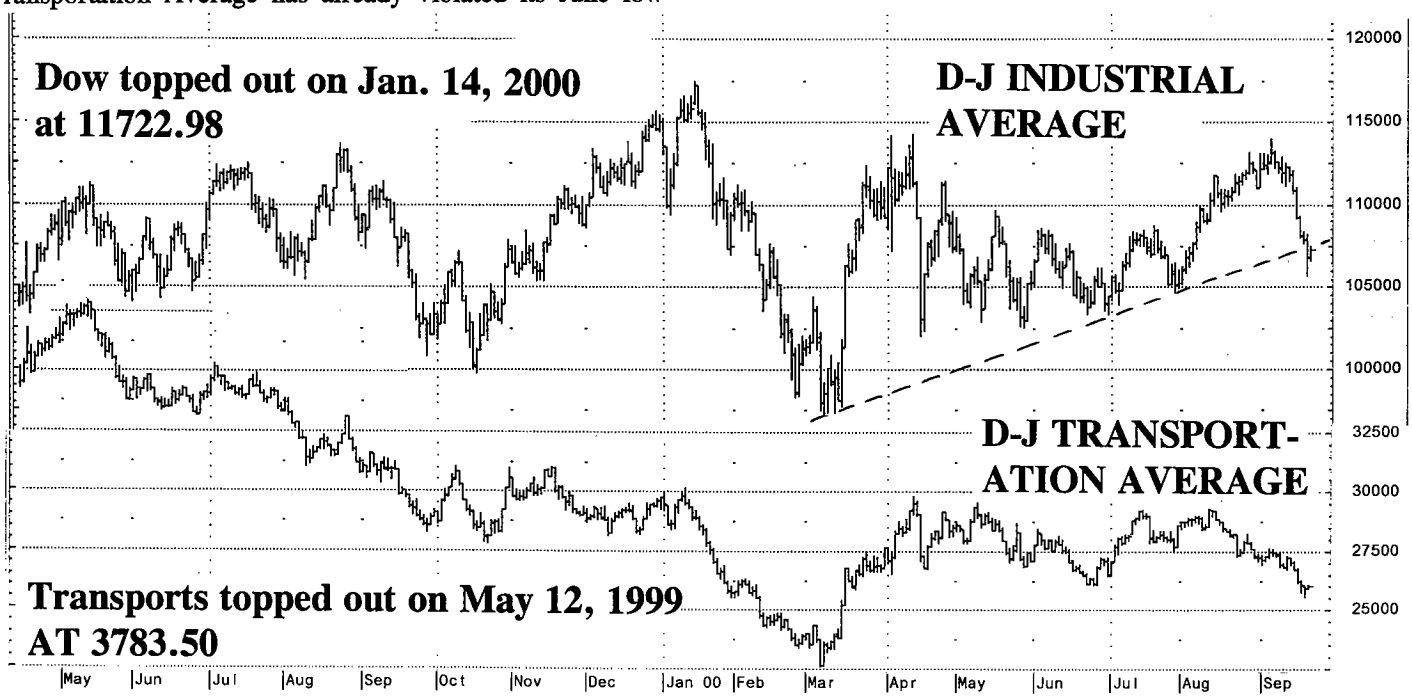
At this point the Dow Theory comes to the fore. The D-J Transportation Average has already violated its June low

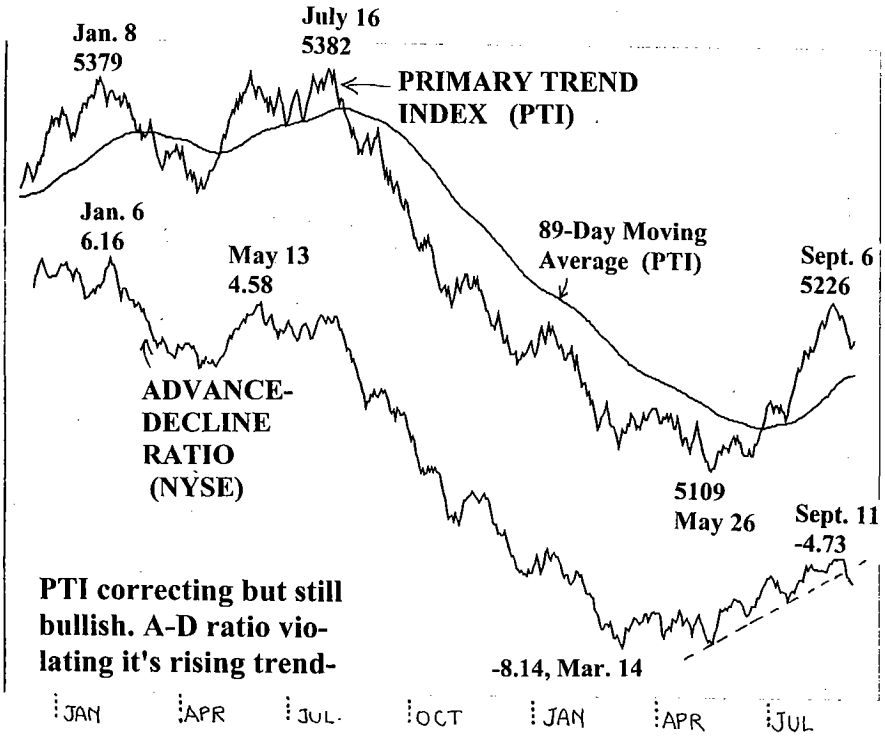
Sept 8, DJIA 11221.76; PTI 5222; A-D Ratio –4.80
Sept 15, DJIA 10927.00; PTI 5212; A-D Ratio –4.93
Sept 22, DJIA 10847.37; PTI 5194; A-D Ratio – 5.82
***Dow Yield: 1.63%; *Dow Price/Earnings: 20.3**
***Dow Times Book Value: 6.62**
***Percentage of Undervalued Blue-chips: 15%**
***Gold 34-day MA: 282**
***(all figures as of 9/22/00)**

(June low was 2612.76). The big question, from a Dow Theory standpoint, is whether the Dow will confirm the Transports. The June low for the Dow was **10376.12.** This is the most important single number in the stock market at this time. If the Dow can hold above 10376.12, this will be a sign that the market intends to "hold together" and ultimately rally.

If the Dow violates 10376.12, however, it will be a signal that the bear has come out of his lair and that a lot of damage lies ahead. So let's keep our eye on that Dow figure of **10376.12.** It's crucial.

Rate-of-growth in a stock or an average is always important. Note on the page 1 chart (which is drawn to semi-log scale) that I have run a trendline extending from the March low to the present. This trendline represents the growth rate for the Dow over the last six months. On Sept. 20 this trendline was violated. This means that the growth rate for the Dow has been interrupted and probably reversed. This is an obvious negative in the market picture.





THE PICTURE – How Did IT Happen? I've been talking about the ridiculous stock valuations for quite some time. But in his latest report, Ned Davis does a much better job than I've done.

Davis revisits a book which is widely referred to as "the bible of security analysis." The book is appropriately named, "Security Analysis" by Graham and Dodd published in 1934.

Graham and Dodd's famous and widely-followed criteria for investment in common stocks were as follows: the stock must provide (1) a suitable dividend return, (2) a stable and adequate earnings record, and (3) a satisfactory backing of tangible assets. If you used any other criteria, the stock you picked was labeled speculative.

This book was published in the early 1930s, and because it came out following the debacle of the 1920s, it created quite a stir. The book literally told investors, "the market's action during the 1920s was illogical, highly speculative and dangerous." This book details the safe and logical way to judge common stocks. Had these criteria been used, stocks never would have climbed to the insane heights of 1929, and consequently, they never would have collapsed and set off the worst bear market in US history.

But how did the mania of the 1920s come about? What happened was that during the 1920s all the classic criteria for valuing stocks were dropped -- jettisoned in favor of new criteria.

The new criteria can be expressed as follows: **the only thing important in judging a stock is the trend of future earnings.** During the 1920s dividends were considered of no consequence, book and tangible assets were considered meaningless -- the only thing that mattered was the trend of future earnings.

On top of this, the thesis was put forth that common stocks represented the most profitable investment avenue for investing. This was "proved" by taking stated intervals of time and showing that in these intervals common stocks outperformed bonds. Thus, the rationale for the great bull market of the 1920s was in place.

The fatal error in all this was that the new analysis ignored PRICE (and classical values) when analyzing stocks. By concentrating on the trend of earnings alone, ANY PRICE could be justified. With classic criteria of valuations ignored, and total emphasis placed on the trend of earnings, the stage was set for the insanity of 1928-29 and the ensuing debacle of 1929-32.

All of which coincides almost exactly to what's happening today -- except that stock prices today are far more detached from classic valuations than was the case during the late 1920s.

Barron's (September 5) included a list of the 20 largest Nasdaq companies along with their earnings/yields, price-to-sales ratios and market capitalizations. In 18 of the 20 cases dividends were non-existent – in the two exceptions, dividends were less than 1%.

The valuations of these 20 stocks was so far from the classic standard put forth by Graham and Dodds as to be unrecognizable. The only one of the 20 which was anywhere near value was WorldCom, but this stock is already down almost 60% from its 1999 high.

It's well to note that in all "new age" valuations, it's almost a given that earning will increase as far into the future as the eye can see. In fact, *Ned David Research* reports that "the consensus forecast for one-year S&P earnings growth has now reached a **record high of 25%,** even surpassing the optimism reached in 1984."

Thus, stocks are priced for massive and continuous growth in earnings -- growth as far as the eye can see.

This explains why we see the current extreme emphasis on quarterly earnings, and why stocks crash when the expected earnings-growth trend is interrupted by a negative report.

Question: How did this whole concentration on earnings-growth get started? What set of circumstances led to the almost complete abandonment of classic valuations?

Answer: The following is strictly a Russell theory. I really think the "new valuations" are an outgrowth of the giant mutual fund industry. This, in turn, is another way of saying it is an outgrowth of fund managers dealing with OPM or "other people's money."

There is a vast difference between buying stocks with OPM through a fund and buying stocks for your own account. If mutual fund managers were restricted to buying only stocks that they would put in their own account, I seriously doubt that we'd see anything like today's valuations. But with thousands of fund managers competing to beat the S&P, something like what we see today was bound to happen.

In the end, sanity will come to the markets, and in the end the time-honored values will come to the fore. But it's going to take time, evidently a lot of time.

What will bring about a return to sane values? I think one of two possibilities: (1) the market stops going up or even drifts lower. This discourages and even damages consumers, and their buying binge comes to a halt. The two phenomena feed on each other, consumers continue to cut back on their buying and the stock market, perceiving this, drifts even lower.

(2) The other possibility is a sudden major break in the stock market as investors start to discount a reversal in the trend of corporate earnings. From there, the bear market takes hold with a vengeance.

INVESTMENT POSITION: The bear remains in the box. And what I call the "attrition phase" of the bear market continues.

The bear at this stage doesn't worry about the professionals. He'll take care of them later. At this earlier stage the bear wants to lock in the public with losses. And from what I gather, from what I hear around, the bear's doing a pretty darn good job.

Everybody I talk to complains of taking a beating in some stock or two or three or even in their entire "portfolios." And the attrition goes on – and on.

What to do? The best thing to do is to put yourself in a position where the "stealth" bear market will not hurt you. This year I thought the safest best position would be in bonds and utilities. That forecast (which is what I've done with my own money) hasn't been far off that mark.

But what about from here on? My choice would be to put about 80% of your money in two to three year safe paper (T-notes or short-maturity muni bonds) and the rest in ten-year T-notes or top-rate muni bonds.

This isn't the time to be cute or adventurous or bold. It's the time to husband your money – it's the time to be careful. The idea is to avoid the bear's game, and the bear's game is attrition. With stocks still drastically overvalued and the primary trend down, "playing" the stock market is like playing at Las Vegas. Play long enough and the house will take your money. It's not a guarantee but it's close to it.

As for the utilities and bonds that I bought, I'm sitting tight.

NOTES & QUOTES: One of the main factors behind the weakness in the euro is the strain of the retirement system in Europe. To keep this system going, it will require either huge and unacceptable tax increases or – well, the various nations pulling out of the EMU. Of course, there is always the choice of inflation, but I don't think that is something we're going to see in Europe.

For the time being, the European "disease" is seen most clearly in the collapsing euro, a currency which evidently fewer and fewer investors or businessmen have any faith in.

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The current thinking: In order to survive in today's business environment, you've got to be big, big, big. This is the reason why so many financial institutions are either up for sale or priced sky-high, meaning that they are attractive bait and ready to be taken over.

The concept is that today a financial institution has to be able to do it all. You've got to be able to sell stocks and bonds and mutual funds, you have to underwrite securities, lend to rich corporations and to people with lousy credit too, you have to advise on takeovers and mergers, manage rich people's money, issue credit cards, and sell insurance. If you can't do most or all of that, hey, you're an old economy outfit and you won't be able to compete.

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What will be TNBT ("the next big thing") in tech? Surprise, giant Intel thinks it's going to be file-sharing technology.

How is that possible? Follow this: 22-year old Ian Clarke is an anarchist. He thinks information should be available for everyone. And he says, down with copyright laws. He's even written a computer program that reflects his thoughts. It's called Freenet. This file-sharing software allows people to

swap music, video, and information files with other online people, much the way Napster and Gnutella do.

But there's a difference -- Freenet is not owned by anyone, it's completely anonymous. Freenet users can't be tracked (Clark originally designed the program to allow people living in fascist states to exercise free speech). The publishing and entertainment industry would love to sue Freenet out of existence. So far, they haven't been able to.

Now the shocker: giant Intel invited Ian Clarke to be a featured speaker in its conference last week. Intel sees these file-sharing programs, Freenet, Napster, Gnutella, as the future. Says Intel's CEO, "Peer-to-peer will be one of the things that shapes the direction of computing going forward." Last week Intel threw its weight behind the peer – to-peer concept. It established a web site to promote sharing. And it promised money and resources to establish new sites. It also formed a peer-to-peer working group that includes 16 start-ups as well as IBM and HWP. **Russell Comment:** The electronic revolution is finished?

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Adding to market volatility is the leverage in the Dow. Because of Citicorp's recent 4 for 3 stock split, the divisor for the Dow has been adjusted to 0.16894073. This means that for each one point change in any of the 30 Dow Industrial stocks, the Average will change by 5.9 points. Thus, a five point rally or decline in any Dow stock will change the Dow by 29.60 points.

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What, more than three-quarters of the advertising on the Web comes from other dot-coms? The dot-coms holding each other up by their own dot-com advertising? With a huge number of dot-coms running out of cash, you can look for a stiff decline in Web advertising (this is already hurting YHOO). "Belt tightening" for dot-coms began last June. Those belts will get a lot tighter in coming months.

77% of Advertising on the Web Is Bought by 'Dot-Com' Firms

■ **Study:** As stronger Net firms rely on ads for revenue, analysts worry that an avalanche of Web failures may cause ripple effect.

By JOSEPH MENN
TIMES STAFF WRITER

A surprising three-fourths of advertising purchased on the World Wide Web comes from other Internet companies, according to a study released Monday by a unit of Media Metrix.

The study of the biggest 200 advertis- ers on the W...

Only last week, shares in top Web portal Yahoo fell more than 15% after Lehman Bros. analyst Holly Becker noted that more than 60% of Yahoo's ads are placed by dot-coms and that in July the total number of ads viewed on Yahoo dropped by 20%.

"As Internet companies' cash reserves dwindle and prospects for profitability aren't near-term, many of these companies are cutting back on spending," said analyst Derek Brown of WR Hambrecht & Co. in San Francisco. "That could have a ripple effect."

Analysts agree that the ... for"

I also note many full page and even two-page ads from dot-coms and B2Bs in the WSJ and other newspapers. Half the time I can't even figure out what these ads are saying and why. Most of the time, I just skip them. To me, it's money down the drain. So far, all these ads have been is a huge boon to the newspapers. I expect that these ads will dribble off over the next six months to a year – I consider them a total waste of money.

* *

The additions and omissions to the S&P 500 are significant. According to Ned Davis, in 1991 there were only 9 changed. Since then (except for 1996) the number of changes has increased each year. In 1999 there were 44 changes. In the year 2000, so far, there have been 31 changes.

Here's the interesting part. The stocks removed from the S&P this year had an average P/E of 26.8 (which is high by historical standards). But the stocks added to the S&P this year have an average P/E of 83.7. This pushed up the overall P/E and overvaluation of the S&P, since most of the stocks added are the so-called "growth-oriented" stocks. Thus the S&P has evolved into a "growth" average rather than a value average. Also, these frequent changes increase the turnover and volatility that index fund managers have to deal with.

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Warren Buffett is doing what he does best – he's buying a successful family business. This time he's offering to buy Shaw Industries, the largest carpet manufacturing company in the nation. It will be a cash deal, and Buffett will pay $2 billion to buy over 80% of the stock in Shaw. Along these same lines, Buffett owns the largest furniture store in Nebraska. These are basic businesses that Buffett understands. Not that there's anything wrong with that.

* *

The year 2000 might go down as the "year of insider selling." Through August, insiders have sold a record $47.1 billion worth of stock. Examples: Paul Allen, co-founder of Microsoft, has sold $6.5 billion of MSFT. Michael Dell has sold $959 million of Dell. Ted Waitt, co-founder of Gateway, has sold $482 million. Henry Nicholas, co-founder of Broadcom, has sold $453 million. In July, insiders sold 22 times more than they bought, as compared with the normal 10 times.

* *

The telecom companies will invest more than $100 billion this year, but analysts claim the money is not being well spent. While capital expenditures have soared 25.5% annually since 1996, telecommunications revenues have increased only a modest 10.5% per year. The result is that for every dollar invested, tele-players are seeing less and less revenue produced. This is probably why the three big long distance companies are all down about 40% for the year. Also, the biggest local-phone companies, Verizon, Bell South and SBC have also seen their shares slide. As for all the dozens of telecommunication upstarts that have been founded over the past few years, many have dropped 75% or more.

* *

Inflation? *New York Times* magazine just came out with a list of prices, 1991 against 1999 (not adjusted for inflation). Price of a one-bedroom Manhattan apartment up 70% in 1999 over 1991; Cab ride JFK to Midtown Manhattan up 11%; Phone hookup up 4%; Extermination for one or two

bedroom apt. up 56%; Subway commute twice a day -- down 9%; NY State driver's license down 38%; One gallon unleaded gas up 55%; Orange juice half-gallon up 31%; Zagat Survey up 20%; Movie ticket up 27%; Suggested admission to Metropolitan Museum up 67%; Yankee ticket (field box) up 167%; Nathan's hot dog up 23%; Prix fixe dinner at La Cote Basque up 18%; NY Health and Racket Club (one year membership) up 46%; Round-trip ticket on Hampton's jitney up 95%. And that's about the story for what's happened to the buying power of the dollar.

DIVIDENDS and TOTAL RETURN: Steve Leuthhold and his group turn out some of the best research obtainable (612-332-1567). In his latest report, Steve notes that the annual compound growth of stocks, with dividends reinvested, is 10.8%. But excluding dividends, the long-term total return drops to 5.9%. Thus, 45% of the annual total return over the last 100 years has come from dividends and the reinvestment of those dividends.

Then Steve notes that the "difference between 5.9% compounded over 100 years and 10.8% compounded is GIGANTIC." This sounds incredible, but here's the difference: $1,000 invested at 5.9% in 1900 grew to $319,694. But $1,000 invested at 10.8% grew to $29,471,614.

Dividends don't matter? Don't tell that to someone who understands compounding.

Market action plays a large part in how and when companies pay dividends. When stocks are going up and producing capital gains, it is said that companies don't have to pay dividends because corporations, in their wisdom, can make better use of the money than simply paying it out in taxable dividends.

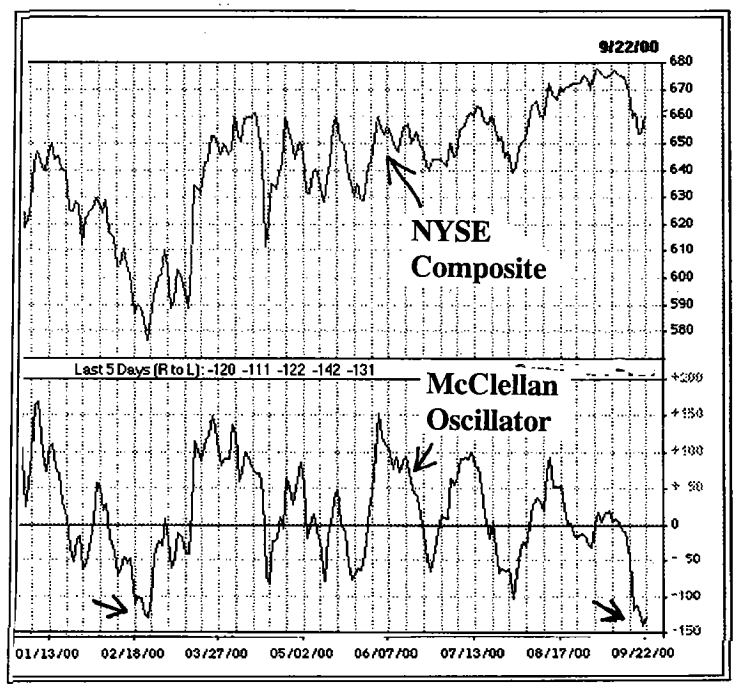
But when times are hard and stocks are down, it is said that dividends are valuable because even if your stock is declining or going nowhere, the dividend is something tangible, the dividend is income, and in hard times income is extremely important and in many cases "a life saver."

Leuthold notes that in 1978 the S&P was priced at less than 10 times earnings while providing a yield of better than 6%. Investors in 1978 were still traumatized by the 1973-74 bear market collapse, and they wanted value and they wanted a return on their investments.

In 1978 66.5% of the stocks on the NYSE, the Amex and the Nasdaq paid dividends. In 1998, however, only 20.7% of stocks on those exchanges paid dividends. Today the percentage has dropped below 20%, largely because the great majority of IPOs and new issues pay no dividends. And as Steve Leuthhold says, "How can they pay dividends? They don't have any earnings."

OVERVIEW: There are a great many studies and devices for showing when a market is overbought or oversold. One that I like is based on the action of the McClellan Oscillator. This is the juxtaposition of two exponential moving averages of the advance-decline line, each moving average being of a different time series.

The chart shown on this page is courtesy of the great web site, www.decisionpoint.com, and is available on the Internet every day. As you can see, the Oscillator has now declined into oversold territory. The last time the Oscillator was down here was in mid-February just before the big rally in the stock market.



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At any rate, **what the market does from an oversold condition is always important** – it can give us hints as to the basic strength or weakness of the market. A powerful rise out of an oversold condition tells us that the stock market is basically strong and that it finds the upside an

easy road to travel. Conversely, a weak "churning" rise out of an oversold condition tells us that the market is weak, it is just working off an oversold condtion -- and that the next decline will probably be severe.

So what do we know at this time? (1) We know that the market or at least the NYSE is in an oversold condition and "should be" ready to rally. If the market can't rally strongly out of this area, then "something is wrong."

(2) We know that the D-J Transporation Average has violated its June low but the Dow has not confirmed. This allows for a rally.

(3) We know that the PTI (page 2 chart) has dropped sharply from its September 6 peak -- but that the PTI is still above its moving average. My own interpretation is that the PTI is still in its bullish mode -- but unlikely to record a new high. This is an important consideration in the big picture.

(4) At the same time, however, note (page 2 chart) that the advance-decline ratio has violated its rising trendline. For this reason, it's questionable whether the A-D ratio will be able to advance to new recovery highs. This is also a very important consideration in the big picture.

(5) We know that with a national election coming up in two months, the Fed is flooding the market with money and the various money supply indicators are heading due north. With the market now oversold and with the money supply surging, if the stock market cannot now mount a significant rally, we'll know that something is wrong. If that's the case, I'd infer that the stock market in its own subtle way is telling us that major trouble lies somewhere ahead. Or to put it another way, I'd infer that the stock market is "marching to the beat of a different drummer."

NASDAQ: I want to show the current position of the Nasdaq -- and at the same time illustrate my method of reading the moving averages. I'm using the Nasdaq because brokers tell me that when customers call they want to know what the Nasdaq (not the Dow) is doing.

On the daily chart (below, left) we see a 50-day MA and a 200-day MA. During a powerful advance, the 50-day MA will advance above the 200-day MA. If the advance lacks power or duration, the 50-day MA will fail to move above the 200-day MA, in which case, I will watch the price action of the item.

Note that in the rally to the August peak, the Nasdaq not only formed a "double top" but failed to pull the 50-day MA above the 200-day MA. This was an indication of weakness. The Nasdaq then dropped back below both MAs.

At this point I told subscribers on my website that the Nasdaq gave a "sell signal" and was in its "sell mode." From its low of last week the Nasdaq attempted a weak rally, and then on September 22 ((Friday) the Nasdaq gapped down, a further sign of weakness (the excuse for the weakness was the announcement by Intel of weaker sales in Europe).

Of course, the Nasdaq was already in a very weak technical condition and any adverse news would have served to knock it down. The question now is whether the Nasdaq will be weak enough to break below the 3500 support level.

GOLD: There really isn't a lot new that I can say about gold. Frankly, I'm worn out from reading endless papers on why gold "should" be doing this or that. **I'm more interested in what gold is actually doing.**

On Friday (Sept. 22), as the dollar got whacked by international intervention to "save" the euro, Dec. gold surged as high as 279.20 -- actually above its 34-day moving average (which stands at 278.30). But sadly, Dec. gold closed at 275.10, down 3.20 from its intra-day high. I didn't think that was a good performance.

NEXT MAILING: September 27, 2000